

***OCTOBER 30, 1996, RSFA OUTREACH MEETING MINUTES
ON TAKES AND ENTITLEMENTS/MARGINAL PROPERTY EXCEPTION***

PARTICIPANTS:

Roman Geissel, MMS
Luke Lundmark, MMS
Lydia Barder, MMS
Cathy Hamilton, MMS
Valdean Severson, State of New Mexico
Carla Wilson, RMOGA
Ben Dillon, IPAA
David Herbaly, Herbaly Petroleum Corp.
Barbara Widick, IPAMS
George Butler, Chevron
Kevin Karl, MMS - Gulf of Mexico Region
T. Scott Williams, MMS - Gulf of Mexico Region
Paula Neuroth, MMS
Debbie Briggs, MMS
Lonny Bagley, BLM - Washington Office
Mary Williams, MMS
Hank Szymanski, BLM - Colorado State Office
Lynn Fenimore, Apache
Tammy Naron, Apache
Ernest Altgelt, Western States Land Commissioners Association - Texas
Nancy Nava, Western States Land Commissioners Association - Texas
John Clark, COPAS
Bob Wilkinson, RMOGA
Mary Stonecipher, RMOGA
Patsy Bragg, Mid-Continent Gas
Recorder: Lydia Barder

Roman Geissel opened the meeting with introductions and set forth the agenda as the list of questions sent out with the meeting notice. Discussion topics included the concept of takes v. entitlements, the reporting associated with takes and entitlements, and the marginal properties exception. Roman mentioned the draft of our "Dear Reporter" letter. MMS wants to refine it so it becomes a vehicle for establishing interim guidelines. We want to send out the "Dear Reporter" letter by 12/96, if not earlier. We hope to complete the draft regulation by the end of 01/97 and publish the final regulation by the end of 1997.

MMS ASSUMPTIONS

One regulation covers the reporting and payment requirements for all Federal leases and agreements except leases classified as privately acquired. This regulation also covers the requirements for obtaining alternative methods of reporting and paying royalties. This includes an exception for marginal properties which requires a collaborative effort with each concerned

State prior to establishing production thresholds.

ISSUES INVOLVING ROYALTY REPORTING AND PAYMENT

(Takes and Entitlements)

1. Does the regulation apply to sales from inventory or recovered injection that occur in September 1996?

Discussion: While strict interpretation of the law would allow the law to apply to only sales from production produced in September 1996, the consensus was it would create a burden for industry if they would have to distinguish between sales from September 1996 and other months. MMS agreed. The Act covers any sales of production made in September 1996, regardless of when it was produced.

2. How should the regulation specifically define the 100 percent Federal property subject to "takes" reporting? Currently, MMS defines this as a Federal lease, or portion of a lease, that has production not allocated to or from a unit participating area (PA) or communitization agreement (CA). MMS also defines a 100 percent Federal property as an agreement (unit PA or CA) in which all tracts are Federal, have the same royalty rate, and have the same royalty distribution (same surface management agency and State).

Discussion: Industry questioned the fact that the Act refers to a unit agreement, not a PA. MMS explained that production reporting is at the PA level and royalty reporting ties a lease to the PA level via a revenue source. Since MMS looks at agreements at the PA level, everyone agreed to the concept of looking at the PA rather than the entire unit in determining the 100 percent Federal property. In addition, if we roll up the classification to the unit level, less properties would qualify for the 100 percent Federal determination.

We discussed the meaning of "same fund distribution." MMS takes distribution to the State level, not the county level. To ensure that there is no misinterpretation on this issue, industry requested a list of the 100 percent Federal properties. They also wanted the non 100 percent Federal agreements identified. MMS indicated that the list identifies only the 100 percent Federal agreements which number over 2000. Industry asked if the list was at the payor level. MMS stated that the list is at the agreement level, but does reflect leases and revenue sources.

Since the list will be available only through the MMS's Worldwide Web Homepage, industry noted that some companies won't be able to obtain the necessary information because they don't have access to the Internet. MMS stated that the "Dear Reporter" letter will provide a phone number at MMS where they can obtain information.

3. How should the regulation specifically define the properties subject to "entitlement" reporting? Currently, MMS defines this as a Federal lease with less than 100 percent Federal mineral interest or an agreement that does not meet the criteria established in number 2.

Discussion: Everyone basically agreed to this concept. However, there was some discussion on whether or not companies can continue to report on an entitlements basis on stand-alone leases if all parties agree. The law gives no exception to reporting on takes for stand-alone leases. All

parties would be required to report on takes for lease-basis production.

Since RSFA dictates when takes and entitlements reporting is required, the question of what is a company's ultimate liability came up. One industry representative thought that since he's ultimately liable for his entitled share, he's not required to report on takes. Even if he took more than his entitled share, he is only liable for his entitled share. However, most disagreed. Many at MMS agree to the concept that on 100 percent Federal properties, taking means liability. All participants agreed for 100 percent Federal properties, the reporting responsibility is on takes. Some parties suggested that MMS should have some leverage on this issue. If a company fails to report on takes, MMS should assess for incorrect reporting.

4. At what point does MMS contact the operating rights owner(s)/lessee(s) of record when we identify an underpayment of royalties based on a difference between the sales/transfer volumes reported on the monthly production report and the sales volumes reported on the monthly royalty report?

Discussion: Still needs resolution.

5. How should MMS define the term "dispute" as it is used in Subsection 6 (d) (5)?

Discussion: Still needs resolution.

ISSUES INVOLVING THE ALTERNATIVE METHODS OF ROYALTY REPORTING AND PAYMENT

1. Who must contractually agree to an alternative method of reporting and payment for agreements? Is concurrence required from State and/or private lessees?

Discussion: Still needs resolution.

2. Should MMS require the agreement operator to submit the request for an alternative method of reporting on behalf of the lessee(s)?

Discussion: Still needs resolution.

3. Do the requirements of this part of the Act apply to requests made under the marginal property reporting exception?

Discussion: Everyone agreed that this part of the Act does not apply to the marginal property exception since reporting on takes under the exception should be optional.

ISSUES INVOLVING THE MARGINAL PROPERTY REPORTING EXCEPTION

1. What is meant by the term "lease" as applied to a marginal property? For purposes of this section, we are defining a "lease" as an agreement/operator combination.

Discussion: Considerable debate occurred on the subject of what constitutes a marginal property. All agreed that the Act does not adequately define a marginal property. Some parties wanted the property at a lease level in an agreement or at a working interest owner level in the agreement. MMS proposed the concept that a marginal property should be at the PA or CA level. Some parties stated that taking it to the agreement level will prohibit the small

independents from qualifying, which is in conflict with the intent of the marginal property exception.

Arguments for taking the classification down to the lease level in the agreement concerned scenarios where your lease had no well/production, and therefore, should receive the marginal property exception. If your lease has no production, why should you pay out of pocket? However, some felt we should consider allocated production at the lease level. In other words, if your lease had no wells on it or had no production, but still had allocated production, the calculation would include allocated production since allocated production holds your lease in a producing status.

We discussed whether or not a technical amendment to the Act was required to change the definition of a marginal property. Many felt that a technical amendment was not necessary since the pending regulation could address the definition.

We all agreed that the definition of a "lease" under the marginal property definition requires further discussion. MMS will issue an option paper on the three options discussed; i.e., define the term "lease" at: 1) lease level using production from wells on the lease plus any allocated production from associated agreements, 2) CA or PA property level using all CA or PA production, or 3) CA or PA property level using each individual working interest owner's sales from the agreement.

Still needs resolution.

2. There are some agreements that have both Federal and Indian lease participation. Are these agreements eligible for a marginal property exception for the Federal share?

Discussion: Still needs resolution.

3. Should MMS publish a general definition of a marginal property applicable to both onshore and OCS properties? What part of the marginal property definition can be modified by the concurrence of the Secretary and the States? For example, could they modify the daily production levels or the method of calculating the average production?

Discussion: We had some discussion on the subject of what part of the marginal property definition can be modified by the concurrence of the Secretary and the States. One State thought that only the production levels could be altered, but not necessarily the methodology. This issue still needs resolution.

The States questioned how MMS would solicit input from them on the production level thresholds. What vehicle will MMS use to notify the States that the Act exists and that MMS requires input to define a marginal property in order to implement the exception? We adopted recommendations on following in the footsteps of the 205 Delegation Team. MMS will send a letter with the details of the marginal property exception, requesting a point(s) of contact from the respective States in order to foster meaningful discussions with representatives at the State level having expertise in the subject matter.

4. What is the definition of a marginal property? MMS defines a marginal property as a property that produces an average combined equivalent of less than 15 barrels of oil or 90 Mcf of gas per

well per day. In order to determine if a property qualifies for the marginal property exception, we use the total production from all producing wells and the total producing days for the agreement to determine if the agreement qualifies for the exception.

Discussion: Most Participants agreed that the threshold of an average combined equivalent of less than 15 barrels of oil or 90 Mcf of gas per well per day was adequate. However, if we define a property at the working interest owner level, we would not look at average production but the volume of sales that the working interest owner had for the calendar year. You would force the working interest owner to look at all of their interest in the PA or CA and compare it to the threshold. The barrel equivalent would be 5475 barrels (15 Bbls/day X 365 days/year = 5475 Bbls/year.)

MMS indicated that if we are redefining the law to take the qualification down to the working interest owner level, we may reduce the threshold. Since there can be numerous working interest owners within a lease, let alone an agreement, it may be prudent to consider lower thresholds. However, considering all of the working interest owner's interest in the agreement may justify the recommended thresholds. One State claimed that if the 15 barrels and 90 Mcf ceilings were adopted in his State, 90 percent of their agreements would have at least one working interest owner qualify, due to the number of working interest owners in their agreements.

Still needs resolution.

5. There are many situations where communitization agreements overlap a participating area of a unit agreement. How does this impact a marginal property determination?

Discussion: Still needs resolution.

6. Should industry submit an application or a notification for a marginal property determination? What form should the application/notification take (an indicator on an existing form or a new form)?

Discussion: Still needs resolution.

7. What is the earliest sales period that can be reported using the determination?

Discussion: Still needs resolution.

8. Who should submit the application/notification (i.e., lessee, operating rights owner, designee or operator)?

Discussion: It all depends on how we define a marginal property. If it is at the agreement level (PA or CA), the operator would probably submit. If a marginal property is defined at the working interest owner level, the working interest owner would submit.

Still needs resolution.

9. Who should receive the application/notification first, the MMS or the impacted State?

Discussion: Still needs resolution.

10. What qualifying period should be used to determine if a property qualifies for a marginal

property exception for: 1) a currently producing property, 2) a newly completed property or 3) a property returned to production? Would it be the previous 6 calendar months, 12 months or some other period of time?

Discussion: All agreed that we should use a historical period of 12 months to determine a marginal property classification. We decided to keep it to a calendar-year basis. We did not select the actual calendar year for qualification. For newly completed properties or a property returned to production, the company would wait for 12 months before qualifying.

11. How long should the qualification last? For the remainder of the calendar year in which it is granted? Including 1 additional calendar year? Indefinitely?

Discussion: The consensus was that the qualification would last a calendar year.

12. Should MMS require reevaluation if the agreement expands or contracts?

Discussion: Still needs resolution.

13. Should MMS provide routine notification to the operator when a marginal property becomes significantly out-of-balance?

Discussion: Still needs resolution.

14. Can MMS defer interest accrual on overpayments on marginal properties until January 1 of the next calendar year?

Discussion: All agreed that MMS should use the same basis for paying interest that it uses for charging interest under the marginal property exception.

15. When reporting on a takes basis, should royalties be allocated to all leases in the agreement? Not doing so could have an impact in meeting minimum royalty obligations for leases in the agreement.

Discussion: Industry felt strongly that they could report all royalties on volumes they took to their lease. MMS stated that we might bill the other leases in the agreement for minimum royalty if, for example, industry paid on only one lease during the year. Industry stated that the payments that were made on their lease should hold all leases in the agreement and MMS should not issue minimum royalty bills under this scenario.

Industry mentioned that MMS agreed to (actually proposed) reallocating the volumes and royalties reported by payors to all leases in 100 percent Federal agreements. MMS made this agreement prior to RSFA. Industry suggested we speak with MMS upper management to verify the commitment made by MMS to allow industry to report agreement royalties on one Accounting Identification (AID) number within the agreement.

This subject led to discussion on how reporting on only one AID number in an agreement would impact MMS's system with respect to distribution. Since the 100 percent Federal agreement concept requires takes on agreements that could contain multiple counties (the leases in these agreements only require fund distribution to the same State and surface management agency), reporting on only one AID number in the agreement could adversely affect distribution at the

county level, downstream from MMS distribution. MMS would have to reallocate the royalties, under this scenario, since many of the States distribute funds to the county level. One State indicated that since they don't distribute down to the county level, MMS should not charge their State for the effort.

16. If you received a marginal property exception, how should you report the true-up adjustment; i.e., one line in the last sales period or a line for each month requiring a true-up correction?

Discussion: Interest-free true-up adjustments are due by December 31 of each year for months January through November, inclusive. December's true-up adjustment is due by January 31 of the next calendar year. However, some wanted us to consider estimated payments, which would allow November's and December's adjustments to be payable interest free by January 31 and February 28 (or 29), respectively, of the next calendar year. Most agreed that interest-free adjustments should be paid on months January through November by December 31 of the calendar year.

Because working interest owner changes and volume changes due to recalibrations occur during the calendar year, we decided that the true-up adjustments should be reported on a sales-month basis as opposed to a one-line royalty entry for all the adjustments. This would help in determining differences on a sales-period basis since royalty reporting will still tie to the monthly production report.

17.If you sell the property during the year, do you have to true up immediately or can you wait until January of the next calendar year?

Discussion: Still needs resolution.

ADDITIONAL QUESTIONS ASKED AT THE MEETING

1.If I submit for and am granted a marginal property exception determination, can I continue to report on entitlements? This would allow me to make any necessary adjustments interest free during the calendar year.

Discussion: Still needs resolution.

2. Industry: I have a property with "State allowables" where I can only produce out of a well a certain volume. If I produce the volume in 1 hour, I have to shut in the well for the remainder of the month. Can I count the well as producing for the entire month since I am forced to shut in my well?

Discussion: Some MMS, BLM, and State representatives suggested that if the well produced the allowable threshold in one day, it should count as having produced for only one day. The well would have produced additional volume had it been open for production the rest of the month.

3.Will there be an interest-free grace period in order for industry to comply with the change from entitlements to takes reporting and vice versa? It will take some time to make the transition. Industry systems require modifications to comply with RSFA. Would MMS consider allowing industry to make interest-free adjustments on sales months September through November 1996?

Discussion: Still needs resolution.

ACTION ITEMS

- 1.MMS will consult with the Solicitors Office to determine if there is a liability issue that we need to address with respect to takes reporting under RSFA. What recourse under FOGPMA is available to MMS when a company fails to report on takes but reports on his entitled share?
2. MMS will coordinate internally with the Valuation and Standards Division to determine what we require to evaluate whether or not a proposal for an alternative method of royalty reporting and payment reduces the amount of royalty obligation under subsection 6 (d)(3).
- 3.MMS will draft a discussion paper on the 3 options discussed on the definition of a marginal property. MMS will circulate the paper to the parties that were in attendance at this meeting to solicit pro and con arguments. Upon consolidating all the comments, MMS will circulate the paper throughout the Royalty Management Program for additional comments.
- 4.MMS will issue a letter to the governors of the 38 impacted States to request a contact for consultation on the marginal property definition.
5. MMS will verify the commitment made on allowing industry agreement level reporting on one AID number within the agreement. In addition, MMS will research the impact on minimum royalty for a reporting scheme of this nature. If payments are made to only one lease in an agreement, is minimum royalty due on all the other leases?
- 6.MMS will develop a list of issues for consideration by MMS Senior Managers and/or the Solicitors Office.

ISSUES TO BE DISCUSSED AT NEXT MEETING

- 1.At what point does MMS contact the operating rights owner(s)/lessee(s) of record when we identify an underpayment of royalties based on a difference between the sales/transfer volumes reported on the monthly production report and the sales volumes reported on the monthly royalty report?
- 2.How should MMS define the term "dispute" as it is used in Section 6 (d) (5)?
- 3.Who must contractually agree to an alternative method of reporting and payment for agreements? Is concurrence required from State and/or private lessees?
- 4.Should MMS require the agreement operator to submit the request for an alternative method of reporting on behalf of the lessee(s)?
- 5.What is meant by the term "lease" as applied to a marginal property?
- 6.There are some agreements that have both Federal and Indian lease participation. Are these agreements eligible for a marginal property exception for the Federal share?
- 7.Should MMS publish a general definition of a marginal property applicable to both onshore and OCS properties? What part of the marginal property definition can be modified by the concurrence of the Secretary and the States? For example, could they modify the daily

production levels or the method of calculating the average production?

8.What is the definition of a marginal property?

9.There are many situations where communitization agreements overlap a participating area of a unit agreement. How does this impact a marginal property determination?

10.Should industry submit an application or a notification for a marginal property determination? What form should the application/notification take (an indicator on an existing form or a new form)?

11.When should industry submit the application/notification to take advantage of the marginal property exception on a calendar-year basis?

12.What is the earliest sales period that can be reported using the determination?

13.Who should submit the application/notification (i.e., lessee, operating rights owner, designee or operator)?

14.Who should receive the application/notification first, the MMS or the impacted State?

15.Should MMS require reevaluation if the agreement expands or contracts?

16.Should MMS provide routine notification to the operator when a marginal property becomes significantly out-of-balance?

17.If you sell the property during the year, do you have to true up immediately or can you wait until January of the next calendar year?

18.If I submit for and am granted a marginal property exception determination, can I continue to report on entitlements? This would allow me to make any necessary adjustments interest free during the calendar year.

19.Will there be an interest-free grace period in order for industry to comply with the change from entitlements to takes reporting and vice versa? It will take some time to make the transition. Industry systems will require modifications to comply with RSFA. Would MMS consider allowing industry to make interest-free adjustments on sales months September - November 1996?

RSFA REFERENCE

SEC. 6. ROYALTY TERMS AND CONDITIONS, INTEREST, AND PENALTIES.

6 (d) VOLUME ALLOCATIONS OF OIL AND GAS PRODUCTION -- Section 111 of the Federal Oil and Gas Royalty Management Act of 1982 (30 U.S.C. 1721), as amended by subsections (a) through (c), is amended by adding at the end the following:

"(k)(l) Except as otherwise provided by this subsection --

"(A) a lessee or its designee of a lease in a unit or communitization agreement which contains only Federal leases with the same royalty rate and funds distribution shall report and

pay royalties on oil and gas production for each production month based on the actual volume of production sold by or on behalf of that lessee;

"(B) a lessee or its designee of a lease in any other unit or communitization agreement shall report and pay royalties on oil and gas production for each production month based on the volume of oil and gas produced from such agreement and allocated to the lease in accordance with the terms of the agreement; and

"(C) a lessee or its designee of a lease that is not contained in a unit or communitization agreement shall report and pay royalties on oil and gas production for each production month based on the actual volume of production sold by or on behalf of that lessee.

"(2) This subsection applies only to requirements for reporting and paying royalties. Nothing in this subsection is intended to alter a lessee's liability for royalties on oil or gas production based on the share of production allocated to the lease in accordance with the terms of the lease, a unit or communitization agreement, or any other agreement.

"(3) For any unit or communitization agreement, if all lessees contractually agree to an alternative method of royalty reporting and payment, the lessees may submit such alternative method to the Secretary or the delegated State for approval and make payments in accordance with such approved alternative method so long as such alternative method does not reduce the amount of the royalty obligation.

"(4) The Secretary or the delegated State shall grant an exception from the reporting and payment requirements for marginal properties by allowing for any calendar year or portion thereof royalties to be paid each month based on the volume of production sold. Interest shall not accrue on the difference for the entire calendar year or portion thereof between the amount of oil and gas actually sold and the share of production allocated to the lease until the beginning of the month following such calendar year or portion thereof. Any additional royalties due or overpaid royalties and associated interest shall be paid, refunded, or credited within six months after the end of each calendar year in which royalties are paid based on volumes of production sold. For the purpose of this subsection, the term 'marginal property' means a lease that produces on average the combined equivalent of less than 15 barrels of oil per well per day or 90 thousand cubic feet of gas per well per day, or a combination thereof, determined by dividing the average daily production of crude oil and natural gas from producing wells on such lease by the number of such wells, unless the Secretary, together with the State concerned, determines that a different production is more appropriate.

"(5) Not later than two years after the date of the enactment of this subsection, the Secretary shall issue any appropriate demand for all outstanding royalty payment disputes regarding who is required to report and pay royalties on production from units and communitization agreements outstanding on the date of the enactment of this subsection, and collect royalty amounts owed on such production."